

ECONOMIC OUTLOOK

Both the nation and California are at pre-recession employment levels, and steady economic growth is expected to continue for the next few years. When unemployment rates reach historical low levels, inflation tends to rise. However, falling oil prices have kept inflation close to zero at the national level, while higher housing costs in California have resulted in relatively higher state inflation.

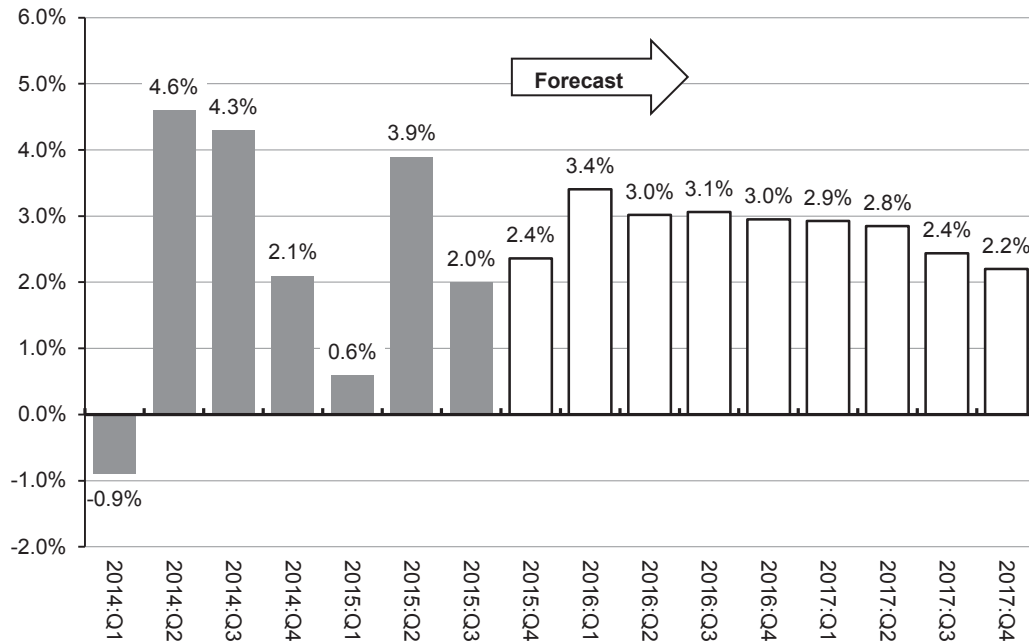
The outlook assumes that growth is solid in 2016 and 2017, and that inflation remains low. However, potential stresses include slower global growth, a correction in the stock market, or a recession sooner rather than later.

THE NATION – CONTINUED GROWTH

After reaching a high of 10 percent in October 2009, the national unemployment rate fell to 5 percent in October 2015, a level last seen in April 2008. The U.S. economy grew unevenly in 2015, although annual real Gross Domestic Product growth is expected to be 2.4 percent. Growth is expected to pick up in 2016 and 2017. (See Figure ECO-01 for details.)

In light of the improvements in the economy, the Federal Reserve raised the benchmark interest rate by 0.25 percentage point for the first time in seven years in December 2015. Interest rates are expected to increase very gradually over the next few years, while inflation is expected to remain around 2 percent. Oil prices have been low and falling since the second half of 2014, leading to inflation below 1 percent in 2015. Prices are expected to begin to rise in 2016, along with inflation.

Figure ECO-01
**U.S. Real Gross Domestic Product
 Quarter-to-Quarter Growth, Annualized**



Source: U.S. Bureau of Economic Analysis; CA Department of Finance Governor's Budget Forecast.

CALIFORNIA – STEADY GROWTH

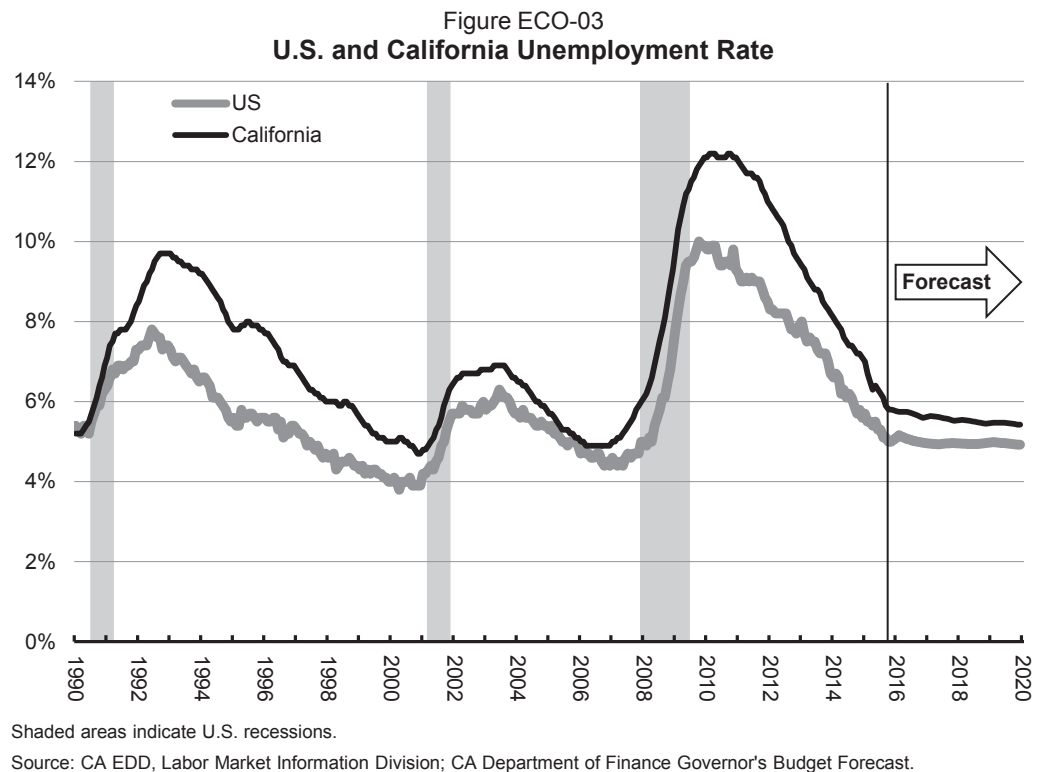
California's economy continues to improve along with the nation. See Figure ECO-02 for highlights of the national and California forecasts. The unemployment rate dropped to 5.7 percent in November 2015 due primarily to the historically low labor force participation rate of 62 percent. It is expected to fall very gradually to around 5.5 percent (Figure ECO-03) as labor force participation stabilizes. Despite a higher pace of retirements from an aging population, the labor force is growing at close to 1 percent a year as younger Californians look for and find jobs. Many of these new entrants to the workforce have benefited from additional years in school, and these higher skills are expected to support higher wage growth. California continues to add jobs at a steady pace, with around 40,000 a month added on average in 2015. Nonfarm employment growth is expected to slow over the next few years as fewer unemployed workers leads to higher wage growth. The fourth consecutive year of the drought resulted in the first decrease in farm employment in 2015 during the drought period. Although the forecast projects modest improvements in agriculture beginning in 2016, the effects of the drought on the farm sector may continue for a few years.

Figure ECO-02
Selected Economic Indicators

United States	2011	2012	2013	2014	2015 Estimated	2016 Projected	2017 Projected
Nominal gross domestic product, \$ billions	\$ 15,518	\$ 16,155	\$ 16,663	\$ 17,348	\$ 17,955	\$ 18,806	\$ 19,743
Real gross domestic product, percent change	1.6%	2.2%	1.5%	2.4%	2.4%	2.9%	2.8%
<i>Contributions to real GDP growth</i>							
Personal consumption expenditures	1.6%	1.0%	1.2%	1.8%	2.2%	2.1%	2.1%
Gross private domestic investment	0.7%	1.5%	0.7%	0.9%	0.8%	0.8%	1.1%
Net exports	0.0%	0.1%	0.2%	-0.2%	-0.6%	-0.5%	-0.4%
Government purchases of goods and services	-0.7%	-0.4%	-0.6%	-0.1%	0.1%	0.4%	0.1%
Personal income, \$ billions	\$ 13,255	\$ 13,915	\$ 14,068	\$ 14,694	\$ 15,310	\$ 15,996	\$ 16,851
Corporate profits, percent change	4.0%	10.0%	2.0%	1.7%	0.3%	7.8%	2.3%
Housing permits, thousands	624	830	991	1,052	--	--	--
Housing starts, thousands	612	784	928	1,001	1,114	1,277	1,437
Median sales price of existing homes	\$ 166,200	\$ 177,200	\$ 197,400	\$ 208,900	--	--	--
Federal funds rate, percent	0.1%	0.1%	0.1%	0.1%	0.1%	0.9%	1.9%
Consumer price index, percent change	3.2%	2.1%	1.5%	1.6%	0.2%	1.7%	2.2%
Unemployment rate, percent	8.9%	8.1%	7.4%	6.2%	5.3%	5.1%	5.0%
Civilian labor force, millions	153.6	155.0	155.4	155.9	157.3	159.6	161.9
Nonfarm employment, millions	131.8	134.1	136.4	139.0	141.9	144.1	146.1
California							
Personal income, \$ billions	\$ 1,691	\$ 1,812	\$ 1,850	\$ 1,940	\$ 2,043	\$ 2,155	\$ 2,268
Made-in-California exports, percent change	11.3%	1.5%	3.9%	3.6%	--	--	--
Housing permits, thousands	47	59	86	86	101	111	129
Housing unit net change, thousands	36	45	59	69	--	--	--
Median sales price of existing homes	\$ 286,040	\$ 319,310	\$ 407,150	\$ 447,010	--	--	--
Consumer price index, percent change	2.6%	2.2%	1.5%	1.8%	1.5%	2.3%	2.6%
Unemployment rate, percent	11.6%	10.2%	8.8%	7.5%	6.2%	5.7%	5.6%
Civilian labor force, millions	18.4	18.5	18.6	18.8	19.0	19.2	19.4
Nonfarm employment, millions	14.4	14.7	15.2	15.7	16.1	16.5	16.7
<i>Percent of total nonfarm employment</i>							
Mining and logging	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Construction	3.9%	4.0%	4.2%	4.3%	4.5%	4.8%	5.1%
Manufacturing	8.7%	8.5%	8.3%	8.1%	8.0%	7.9%	7.8%
High technology	2.4%	2.3%	2.2%	2.1%	2.1%	2.1%	2.1%
Trade, transportation, and utilities	18.6%	18.6%	18.4%	18.3%	18.1%	18.0%	17.9%
Information	3.0%	3.0%	3.0%	2.9%	3.0%	3.0%	2.9%
Financial activities	5.3%	5.3%	5.2%	5.0%	4.9%	4.9%	4.8%
Professional and business services	14.9%	15.2%	15.4%	15.5%	15.4%	15.2%	15.0%
High technology	2.3%	2.4%	2.4%	2.5%	2.6%	2.6%	2.6%
Educational and health services	14.5%	14.8%	15.3%	15.3%	15.0%	15.1%	15.0%
Leisure and hospitality	10.7%	10.9%	11.0%	11.5%	12.3%	12.7%	13.0%
Other services	3.4%	3.4%	3.4%	3.4%	3.3%	3.3%	3.2%
Government	16.7%	16.2%	15.6%	15.4%	15.2%	15.0%	14.9%

Forecast based on data available as of November 2015.

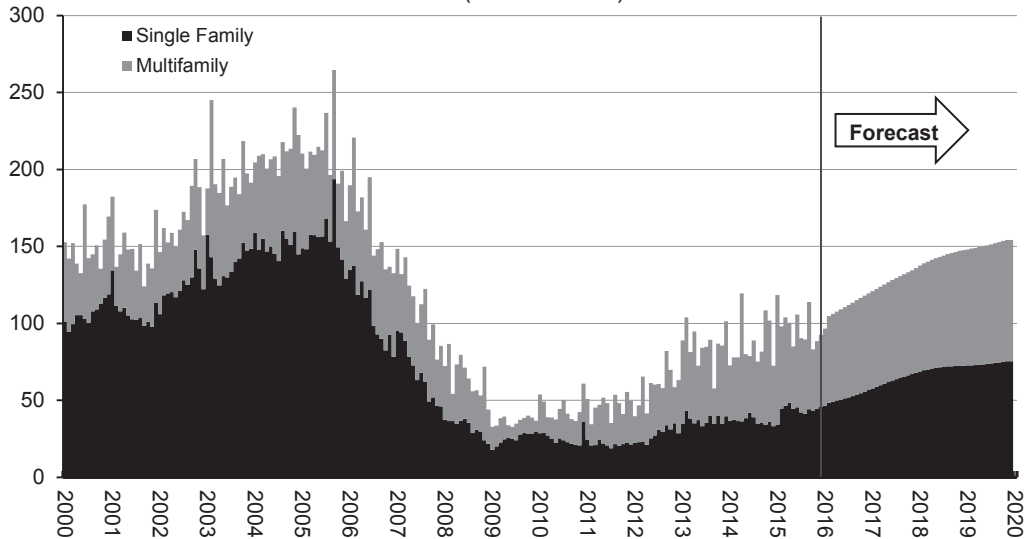
Percent changes calculated from unrounded data.



Personal income has been growing faster than expected. Growth above 5 percent is forecast in 2016 and 2017 as a tighter labor market induces rising wages for more workers, before falling to a more normal growth rate of around 4.5 percent beginning in 2018.

Consumer inflation, as measured by the Consumer Price Index (CPI), has been relatively low throughout the recovery, and is expected to remain around 2.5 percent over the forecast period. Housing prices have been rising faster than the overall index, particularly in the San Francisco area, and are expected to keep inflation somewhat higher than the nation. After a few years of relatively low levels of housing permits being issued, the forecast expects that strong growth will resume in 2016 (Figure ECO-04). Housing prices, as measured by the median sales price of existing single-family homes, are almost double the low reached during the Great Recession, but at \$475,000 are still 20 percent below the pre-recession peak of almost \$600,000. Nonresidential permits are already growing strongly as firms hire more people and expand their businesses.

Figure ECO-04
California Residential Construction Permits
Seasonally Adjusted at Annual Rates
(In Thousands)



Source: CA Construction Industry Research Board; CA Homebuilding Foundation;
CA Department of Finance Governor's Budget Forecast.

RISKS TO CONSIDER

The main risks to the state's economy in the next few years are a slowdown in the global economy or a stock market correction.

It appears that China's growth slowed in 2015, although its stock market has stabilized. There is also some uncertainty about the growth path in the European Union. Slower growth in one or both could dampen U.S. growth as well.

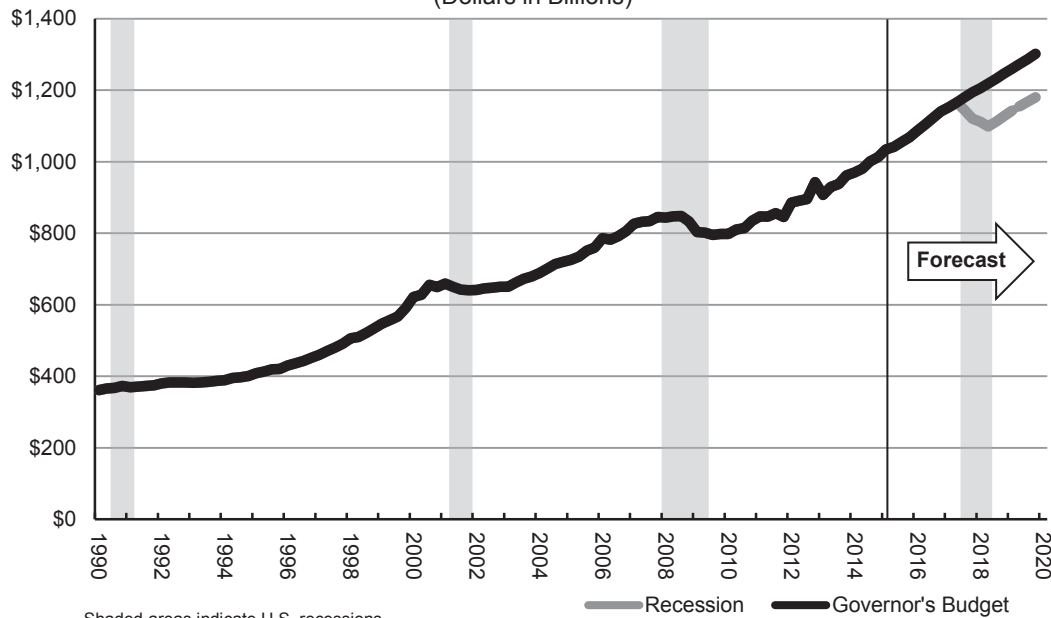
The stock market stabilized following the August correction, but volatility remains. The S&P 500 index was forecast to end 2015 around 2,075. Valuations of technology stocks have also been rising much faster than overall economic growth, contributing to rising wage pressures for high-skilled workers. With many of these workers concentrated in urban areas with limited growth in housing supply, this can also increase competition for housing and raise housing prices.

PLANNING FOR THE NEXT RECESSION

The current expansion has lasted since mid-2009, but on average expansions continue for only around five years. As can be seen in some of the preceding figures, it would

be a historical anomaly for there not to be a recession before 2020. Even a fairly mild recession for the U.S. would be difficult for California. For example, if unemployment rates fell to the point where inflation began to rise, this could trigger a moderate recession in 2017-18. If so, the Department of Finance's recession scenario forecasts U.S. real Gross Domestic Product falling by 0.4 percent and then recovering in the following two years. California would lose almost half a million jobs, and wages and salaries would fall by about 6 percent (Figure ECO-05). Some of these losses would be partially offset by higher unemployment insurance payments and there may be higher growth rates during the recovery that would follow. However, as a recession would likely be accompanied by a large fall in the stock market, revenues would be strongly affected.

Figure ECO-05
California Wages and Salaries Would Drop Below the Forecast During a Recession
(Dollars in Billions)



Shaded areas indicate U.S. recessions.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.